Supreme Court, U.S.
FILED
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(13)

No. 96-842

In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

JAMES HERMAN O'HAGAN

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

WALTER DELLINGER
Acting Solicitor General
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

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1. Respondent argues that his trading in securities on misappropriated confidential information did not violate the federal securities laws. He begins by attacking the factual underpinning of the jury's verdict, which found that he engaged in that form of deception in connection with his securities trading. The jury correctly resolved the factual issues against him.

Respondent first asserts (Br. 3) that, with the exception of one order for 5,000 shares of Pillsbury stock, all his orders for Pillsbury securities were placed with his brokers before August 26, 1988—the date on which partners at Dorsey & Whitney (Dorsey) met to discuss whether to continue their representation of Grand Metropolitan PLC (Grand Met) in its attempt to acquire Pillsbury, and the earliest date, according to respondent (Br. 2), on which he could have confirmed the nonpublic information that a

takeover of Pillsbury was being planned. The jury correctly rejected that contention. The jury was instructed, on the Section 10(b) counts, that "[t]he government must prove beyond a reasonable doubt that the defendant used the material, nonpublic information * * * when he purchased the Pillsbury securities." J.A. 200. It was also instructed, on the Section 14(e) counts, that illegal insider trading with respect to tender offers exists only when "the defendant, knowing that this information came from the corporation, invests in securities using material nonpublic information." J.A. 203. While respondent suggests that he traded on publicly reported news stories rather than material, nonpublic information (Br. 4), the jury was expressly instructed on the difference between public and nonpublic information, see J.A. 198-199, and it rejected that contention. The jury found instead that respondent "used" material, nonpublic information in his trading. That finding, which is supported by the record, is inconsistent with respondent's claim that he placed all of his options orders before he learned nonpublic information about the Pillsbury takeover.[1]

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[1] Respondent begins from the erroneous premise (Br. 3 n.6) that he could not have had nonpublic information before August 26, 1988, and argues that trades before that date were therefore lawful. Thomas Tinkham testified, however, that respondent spoke to him "a few days before" August 26, and that respondent knew by then that the firm "was doing work on a takeover of the Pillsbury company." J.A. 128-129. Respondent obtained the money for his options purchases by executing a mortgage on his home on August 24, 1988; he issued a $200,000 check to the brokerage firm of Robinson Humphrey on August 29, by drawing on a line of credit secured by the mortgage. V Tr. 168; VI Tr. 121-122. That evidence indicates that respondent had nonpublic information about the Pillsbury takeover by August 24 at the latest.

As to the timing of his orders, respondent relies largely (Resp. Br. 3 n.6) on his testimony to the SEC during its investigation. The jury was entitled to discredit those self-serving claims. Even that testimony shows only that respondent told the SEC that he thought he authorized one of his brokers, Steuart Evans, to purchase 500 October 40 options on August 25, but that Evans misunderstood the order to be for 2,000 October 40 options. Moreover, according to respondent's SEC testimony, he learned about Evans' "misunderstanding" on September 7 but agreed to continue purchasing the options to fill out the order for the 2,000 options. J.A. 47-49, 53-54; 12/21/88 Tr. 158-164, 168-172, 176-178, 182-183. That testimony undermines any suggestion that respondent did not make investment decisions (and purchases) after August 26.

Respondent's argument also does not account for another 400 options purchased through Evans or for 100 options purchased through Patricia Kinnahan (his Janney Montgomery Scott broker) that are charged in the indictment. Respondent testified during the SEC investigation that he placed an order for 500 November options with Evans on September 18 (after respondent returned from a honeymoon in Europe). Pursuant to that order, Evans also purchased 100 October 45 options on September 20. Respondent told the SEC that he canceled the order on September 22 after learning the preceding day that Dorsey & Whitney had been involved in the Pillsbury takeover. 12/21/88 Tr. 186-191, 193-197, 204-206, 212-213, 219-224, 255-257. Kinnahan testified at trial that she purchased 100 options charged in the indictment for respondent based on an order placed on August 19, 1988. VII Tr. 108, 112, 163-164. Kinnahan purchased 50 November (she said October) 45 options on August 30, 1988, and 50 November 45 options on September 8, 1988. VII Tr. 108, 112-118. In her June 15, 1989, affidavit to the SEC, however, Kinnahan stated that respondent authorized those purchases when she called him on those two dates. Kinnahan later changed her mind and said, in a second affidavit dated June 24, 1998 (after the indictment was returned), that respondent placed the orders on August 19, 1988. VII Tr. 139-143, 154-158, 163. Given the conflicting affidavits and other testimony, the jury was entitled to disbelieve respondent's evidence and conclude that he had placed the orders charged in the indictment when in possession of nonpublic information confirming Dorsey's representation of a client in a planned takeover of Pillsbury.

Respondent maintains (Br. 5) that the evidence showed only that an undisclosed client had retained Dorsey with respect to a potential takeover of Pillsbury. Respondent does not argue, however, that he owed no fiduciary duty to that client (or to Dorsey) solely because he did not know

the client's name. Respondent knew that Dorsey had been engaged to represent a company in "a takeover of the Pillsbury company," J.A. 129, and he traded on the basis of that confidential information. It is irrelevant that Dorsey's formal client files did not reflect the details of the firm's representation, so that some Dorsey employees would have been unaware of the firm's representation of a client in matters related to a takeover of Pillsbury (see Resp. Br. 1 n.1; J.A. 122). Respondent was aware of that representation, and he therefore had a fiduciary obligation to the firm's client not to convert its information to his own benefit. He also had a similar obligation to his partners. See generally Restatement (Second) of Agency § 431 (1958).

2. a. In arguing that his conduct did not constitute a "deceptive device or contrivance" in violation of Section 10(b), respondent does not dispute that conduct like his has long been held to be *fraudulent*. Nor does he dispute that this Court's decision in *Carpenter* v. *United States*, 484 U.S. 19, 27-28 (1987), holds that a fiduciary's misappropriation of his principal's confidential business information is fraudulent. Instead, respondent argues (Br. 17 & n.19) that his conduct was not *deceptive*. There is no basis, however, for respondent's suggestion that "decept[ion]," as used in the text of Section 10(b), defines a class of acts *narrower* than fraud. To the contrary, a course of conduct that is fraudulent is also deceptive, for the concept of fraud inherently includes deception. "Deceive is to cause to believe the false or to mislead. Defraud is to deprive of some right, interest or property *by deceit*." *United States* v. *Yermian*, 468 U.S. 63, 73 n.12 (1984) (emphasis added).

To narrow the reach of the words "deceptive device," respondent asserts that Section 10(b)'s proscription of deception is limited to the common law tort of deceit. Resp. Br. 15-16. Even if that were true, it would not help respondent. He suggests that the common law tort of

deceit requires an express misrepresentation or nondisclosure, rather than deceptive conduct, and requires proof of reliance. Under the Restatement (Second) of Torts § 525, cmt. b (1977), however, "'[m]isrepresentation' * * * denote[s] not only words spoken or written but also any other conduct that amounts to an assertion not in accordance with the truth." Respondent's conduct misled Dorsey and Grand Met into believing that he was a loyal employee, and he failed to make required disclosures to his principals, to their detriment. See pp. 6-7, 9, *infra*.

In any event, this Court has made clear that "[a]ctions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims, and are in part designed to add to the protections provided investors by the common law." *Basic Inc.* v. *Levinson*, 485 U.S. 224, 244 n.22 (1988) (citation omitted); see also *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 388-389 (1983) ("the antifraud provisions of the securities laws are not coextensive with common-law doctrines of fraud"); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 744-745 (1975) ("the typical fact situation in which the classic tort of misrepresentation and deceit evolved was light years away from the world of commercial transactions to which Rule 10b-5 is applicable").[2]

Respondent also argues (Br. 19) that the misappropriation theory of liability under Section 10(b) is inconsistent with *Santa Fe Industries* v. *Green*, 430 U.S. 462 (1977), which holds that a mere breach of fiduciary duty, without deception, does not violate Section 10(b). Respondent

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[2] See generally Louis Loss & Joel Seligman, *Securities Regulation* 3429-3430 (3d ed. 1989) ("courts have repeatedly said that the fraud provisions in the SEC Acts * * * are not limited to circumstances that would give rise to a common law action for deceit"); Adam Ingber, *10b-5 or Not 10b-5?: Are the Current Efforts to Reform Securities Litigation Misguided?*, 61 Fordham L. Rev. S351, S380 n.147 (1993) (summarizing differences between common law fraud actions and antifraud provisions of federal securities law).

suggests that, under the misappropriation theory, even the *Santa Fe* defendants would be found to have engaged in deception by impliedly misrepresenting that they were acting honestly and in the best interests of the business, and yet the Court found in that case that there was no deception. Respondent argues that the Court in *Santa Fe* must have rejected the view that an implied misrepresentation in a breach of fiduciary duty is a deceptive device. Resp. Br. 19. *Santa Fe*, however, is not inconsistent with the misappropriation theory.

Contrary to respondent's claim (Br. 19), the misappropriation theory does not posit that every breach of a fiduciary duty necessarily entails deception. Rather, liability under the misappropriation theory is premised on the fact that the particular breach of duty involved in the conversion of confidential information that has been entrusted to one for a limited purpose inherently involves deception. Thus, under well settled principles, before an agent may use his principal's confidential business information for his personal benefit, he must make disclosure to the principal and obtain the principal's consent; the breach of that duty thus inherently involves deceptive nondisclosure.[3]

[3] The common law rule requiring an agent to make disclosure to his principal before trading on information belonging to the principal is well established:

> § 395 Using or disclosing confidential information
>
> *Unless otherwise agreed*, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as an agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge.

Restatement (Second) of Agency § 395 (1958) (emphasis added). By requiring that the principal and agent agree to any use of the principal's information by the agent, the Restatement makes clear that disclosure to the principal is required. See *id.* cmt. e ("In obtaining consent of the principal to use or disclose confidential information, the agent is under the duty of disclosure stated in Section 390."). See also *id.* § 390 (agent, when acting on his own account in a matter in which the principal is interested, must "disclose to [the principal] all facts which the agent knows or should know would reasonably affect the principal's judgment"), cmt. a ("an agent has a duty, not only to make no misstatements of fact, but also to disclose to the principal all relevant facts fully and completely," including "the fact that the agent is acting on his own account"); *id.* § 381, cmt. d ("If the agent * * * is competing with the principal and using information acquired during his agency, he is under a duty to the principal to reveal such facts in accordance with the rules stated in Sections 389-392.").

Trustees have similar obligations to obtain the consent of, and furnish information to, their beneficiaries, and a trustee's breach of those obligations rests on nondisclosure.[4] In this case, therefore, it is respondent's failure to disclose his personal trading to Grand Met and Dorsey, in breach of his duty to do so, that makes his conduct "deceptive" within the meaning of Section 10(b).[5]

[4] See Restatement (Second) of Trusts § 170(2) (1959) (trustee dealing with beneficiary on his own account must disclose all material facts), *id.* cmt. a (trustee may not profit at the expense of, or compete with, beneficiary, without consent or authorization under the terms of the trust), *id.* § 173 cmt. d (trustee must disclose material facts that the beneficiary does not know but needs to know for his protection in dealing with a third person with respect to his interest).

[5] It is in that sense that here, as in *Carpenter*, the agent's posing as a loyal employee constitutes deception. Respondent's pose also went beyond silence, in breach of his duty to disclose his personal trading. He engaged in deception in his conversation with Thomas Tinkham by feigning an interest in working on the Pillsbury takeover litigation. Respondent erroneously states (Br. 20) that the record does not show such feigning, and that the government has not previously made that contention. Tinkham testified that he thought that respondent's request to work for him was unusual because respondent was senior to him in the firm's hierarchy, J.A. 131, thus implying that respondent had an ulterior motive. The government argued to the jury that

The particular nature of the duty breached by respondent distinguishes this case from *Santa Fe*, where the complaint alleged "a breach by the majority of its fiduciary duty to deal fairly with the minority" by undervaluing the minority's stock in a short-form merger. *Green* v. *Santa Fe Industries*, 533 F.2d 1283, 1285 (2d Cir. 1976), rev'd, 430 U.S. 462 (1977). Deception was not necessary to breach the duty of fairness there, and there was no suggestion that the majority had a fiduciary duty to accuse itself of financial unfairness after having fully disclosed the terms of the merger. As the Second Circuit recognized in *O'Neill* v. *Maytag*, 339 F.2d 764, 767 (1964),

> [b]etween principal and agent and among corporate officers, directors and shareholders, state law has created duties which exist independently of the sale of stock. While the essence of these duties in some circumstances is honest disclosure, * * * [other cases] are typical of situations in which deception may be immaterial to a breach of duties imposed under common law principles.

Santa Fe involved an alleged breach of duty in which deception was "immaterial." 553 F.2d at 1285. This case, in contrast, presents a situation in which the "essence" of the agent's duty requires "honest disclosure." *Ibid.*

The jury in this case was instructed accordingly. The court charged, without objection, that "[u]nless otherwise agreed, an agent has a duty to the principal not to use or to communicate information confidentially obtained by him

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respondent "confirm[ed] the information he somehow learned [about the Pillsbury takeover] by approaching Tom Tinkham in his office and engaging Tom Tinkham in conversation." XI Tr. 74. The government also argued to the court of appeals that respondent had "feigned an interest in working on the case," and had "masqueraded as a loyal, trustworthy partner for the purpose of drawing information out of Tinkham." Gov't C.A. Br. 8, 49.

from the principal." J.A. 197. Respondent breached that duty by failing to disclose to Dorsey and Grand Met that he planned to buy Pillsbury securities on confidential client information and failing to obtain their agreement to that plan. His use of the information, resulting from that breach, constituted deception. And, contrary to respondent's claim (Br. 19), his deception lulled his principals into inaction that worked to their detriment. Respondent's pose of loyalty deprived Grand Met and Dorsey of the opportunity to protect Grand Met's exclusive right to use its confidential business information, thus jeopardizing interests of both Grand Met and Dorsey.[6]

There is no merit to respondent's claim (Br. 20-21) that the Section 10(b) convictions cannot stand because the indictment did not charge him with deception, and because the jury was not expressly instructed that it had to find "deception." In fact, the indictment did charge deception.[7]

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[6] Thomas Tinkham testified that, if respondent had disclosed that he was trading in Pillsbury securities during September, Tinkham would have considered it to be "a very significant problem for the firm and an enormous breach of trust." V Tr. 99 (Resp. Br. in Opp. App. 17a). Tinkham explained: "[A]s lawyers representing a client, we have an obligation not to use information from that client for our own benefit." V Tr. 100 (Resp. Br. in Opp. App. 17a-18a). Tinkham testified that had he known about the trading, "I would have been more than a little upset." *Ibid.* See also J.A. 102-103 (testimony of Alan Parker that Cravath, Swaine & Moore, as Grand Met's lawyers, "had a legal obligation to insure that the information would not fall into the hands of people who would appropriate it for improper use," and explaining that leaks or misuse of takeover plans would harm Grand Met by driving up price of Pillsbury shares).

[7] The indictment expressly charged that respondent "did use and employ manipulative and deceptive devices and contrivances in connection with the purchase and sale of securities" (J.A. 16), and did "engage in acts, practices and courses of business which would and did operate as a fraud and deceit upon Grand Met and Dorsey and Whitney" (J.A. 17).

And the conduct described in the instructions (J.A. 195-198) and found by the jury—use of a principal's confidential information without the principal's agreement—is inherently a form of deception, just as under the classical theory of insider trading, an insider's trading in his corporation's own securities in breach of a duty to disclose or abstain is inherently deceptive. Cf. *Chiarella* v. *United States*, 445 U.S. 222, 230 (1980).

b. In contending that his conduct was not "in connection with" the purchase or sale of a security within the meaning of Section 10(b), respondent argues that the statute prohibits only fraud "between parties to a securities transaction" (Br. 23), or fraud "on a participant in a securities transaction" (Br. 24 n.27 (emphasis omitted)). Those limitations are not found in the statutory language and conflict with this Court's cases.

Respondent's assertion (Br. 28) that Section 10(b) contains a "textual requirement that deception * * * occur between parties to a securities transaction" cannot be reconciled with *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971). There, a corporation's insiders defrauded the corporation by directing it to sell the corporation's Treasury bonds and then misappropriating the proceeds of the completed sale. The Court found that fraud to be "in connection with" the sale of the bonds, even though there was no fraud *between* the parties to the transaction, *i.e.*, the buyer of the bonds committed no misconduct. *Id.* at 9-10. Nor is there merit to respondent's "participant" test (see Resp. Br. 24 n.27). In *United States* v. *Naftalin*, 441 U.S. 768 (1979), the Court held that Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. 77q(a)(1), which prohibits fraud "in the offer or sale of securities," is not limited to fraud perpetrated on participants in a securities transaction. The Court stressed there that the antifraud provisions of the securities laws are not limited to the protection of investors, but extend to "frauds perpetrated upon *either business or* investors." 441 U.S. at 776 (emphasis added).[8]

Bankers Life and *Naftalin* demonstrate that Congress used the phrase "in connection with" in its ordinary meaning, as "related to" or "involving." Respondent's fraud was "in connection with" his purchases of Pillsbury securities because, as in *Bankers Life*, his trades were a necessary element of his fraud. The nonpublic information about the Pillsbury takeover had no value to respondent personally except as it might enable him to reap windfall profits in the securities market (or enable someone else to reap such profits, through illegal tipping). Thus, contrary to respondent's assertion (Br. 23), his deceptive fiduciary breach and his purchase of securities were connected, because the breach was consummated *by* his purchase of securities.

Respondent suggests (Br. 24) that by prohibiting frauds on the source of information used for securities trading,

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[8] Respondent relies (Br. 25-26) on passages from this Court's opinions in *Chiarella* v. *United States*, 445 U.S. 222, 230 (1980), where the Court stated that liability under Section 10(b) "is premised on a duty to disclose arising from a relationship of trust and confidence between parties to a transaction," and *Dirks* v. *SEC*, 463 U.S. 646, 663 n.23 (1983), where the Court noted that Section 10(b) prohibits "intentional or willful conduct designed to deceive or defraud investors." Those passages, however, merely reflect the nature of the facts and legal claims made in those cases; they were not intended to resolve the question of liability under Section 10(b) in cases like this one, where deception is practiced on the source of the material, nonpublic information used in securities trading but not on a party on the other side of the trade. The Court expressly reserved the validity of the misappropriation theory in both cases. See *Dirks*, 463 U.S. at 665 ("Nor did Dirks misappropriate or illegally obtain the information."); *Chiarella*, 445 U.S. at 236-237. See also *Bateman, Eichler, Hill Richards, Inc.* v. *Berner*, 472 U.S. 299, 313 n.22 (1985) ("We have also noted that a tippee may be liable if he otherwise 'misappropriate[s] or illegally obtain[s] the information.'") (citing *Dirks*, 463 U.S. at 665).

the misappropriation theory departs from the concern of the securities laws to protect investors. That is incorrect. No less than classical insider trading, trading on misappropriated information damages capital markets and diminishes the public's faith in honest securities markets. As the House Report noted when the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, 102 Stat. 4788, was enacted, "the small investor will be—and has been—reluctant to invest in the market if he feels it is rigged against him." H.R. Rep. No. 910, 100th Cong., 2d Sess. 8 (1988). If investors believed that the securities markets were characterized by trading on misappropriated information, and that they could not look to the securities laws and the SEC for protection from such overreaching, the liquidity of those markets and capital formation would suffer. That result would injure the public interest that the SEC is charged with protecting under Section 10(b).

c. Respondent also argues (Br. 30-33) that application of the misappropriation theory raises serious questions of due process, because, he maintains, the theory provides insufficient guidance as to the conduct that is criminal. That argument is without merit.

First, to establish a criminal violation of Section 10(b), the government must show that a person violated that provision "willfully." 15 U.S.C. 78ff(a).[9] To act willfully, the defendant must realize that he is committing a wrongful

[9] 15 U.S.C. 78ff(a) states in relevant part: "Any person who willfully violates any provision of this chapter * * * or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this chapter * * * shall upon conviction be fined to not more than $1,000,000, or imprisoned not more than 10 years, or both * * * ; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation."

act. See *United States* v. *Charnay*, 537 F.2d 341, 352 (9th Cir. 1976); *United States* v. *Dixon*, 536 F.2d 1388, 1397 (2d Cir. 1976); *United States* v. *Peltz*, 433 F.2d 48, 54-55 (2d Cir. 1970), cert. denied, 401 U.S. 955 (1971). Because the government must prove consciousness of wrongdoing, "the accused cannot be said to suffer from lack of warning or knowledge that the act which he does is a violation of the law." *Screws* v. *United States*, 325 U.S. 91, 102 (1945) (plurality opinion). "This requirement of the presence of culpable intent as a necessary element of the offense does much to destroy any force in the argument that application of the [Act]" in these circumstances would be unfair. *Boyce Motor Lines, Inc.* v. *United States*, 342 U.S. 337, 342 (1952); see also *Village of Hoffman Estates* v. *The Flipside, Hoffman Estates, Inc.*, 455 U.S. 489, 499, 502 (1982); *United States* v. *United States Gypsum Co.*, 438 U.S. 422, 445 (1978); *United States* v. *Ragen*, 314 U.S. 513, 524 (1942).

Second, the misappropriation theory is not impermissibly indefinite because it involves proof of a breach of a fiduciary or similar duty of trust and confidence. The classical insider trading theory requires courts to consider whether the trader was under a fiduciary or similar duty creating an obligation to disclose or abstain from trading, and the types of relationships considered in that context are often comparable to the relationships at issue in this case.[10] The misappropriation theory extends only

[10] As this Court has made clear, the obligation to disclose or abstain from trading on material, nonpublic information rests on a legal duty of trust and confidence, and the courts must consider in each case whether the defendant charged with illegal trading had a legal duty not to take unfair advantage of the material, nonpublic information that he or she possessed. See *Chiarella*, 445 U.S. at 229. As this Court has noted, "temporary insiders" such as attorneys, accountants, underwriters, and consultants may have such a duty not to trade on nonpublic information, *Dirks*, 463 U.S. at 655 n.14, on the basis of courts'

to those who breach a recognized duty, based in a particular relationship and "in accordance with [a] common-law rule," *Chiarella*, 445 U.S. at 227, not to disclose, nor to use information for their own benefit, without obtaining consent. See *United States* v. *Chestman*, 947 F.2d 551, 567-568 (2d Cir. 1991) (opinion of Meskill, J.), cert. denied, 503 U.S. 1004 (1992). A person who has such a well established duty has no claim to surprise when its breach, by trading on material, nonpublic information belonging to another, supports liability under the federal securities laws.[11]

Third, there can be no contention that respondent lacked adequate notice of the applicability of the misappropriation theory to his trading. "[T]he touchstone is whether the statute, either standing alone or as

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consideration of their entry into a "special confidential relationship" with the business, in which they received information solely for a corporate purpose. *Ibid*.

[11] A lawyer in respondent's position is particularly poorly situated to claim surprise. *Amici* Professor Painter, *et al.*, suggest (Br. 22) that respondent's conduct did not unequivocally violate the standards for lawyers drafted by the American Law Institute (ALI). See *Amici* Br. 22 (citing Draft Restatement (Third) of the Law Governing Lawyers § 111(1)). In fact, the ALI's draft Restatement in August 1987 made clear that lawyers may not "use or reveal confidential client information . . . even if arguably incurring no risk to the interests of the client, if doing so is solely for the lawyer's own enrichment." Restatement § 112 (Preliminary Draft No. 2 (1987)) (quoted in Ann M. Hart, *The* Model Rules *Are Close and the* Restatement *Is Closer*, 10 Geo. J. Legal Ethics 192, 196 n.92 (1996)). And in a later draft, the ALI eliminated the loophole noted by Professor Painter, by stating that a lawyer is prohibited "from using or disclosing confidential client information for the lawyer's personal enrichment, regardless of lack of prejudice to the affected client." Restatement (Third) of the Law Governing Laywers § 112(2), cmt. j (Proposed Final Draft No. 1, Mar. 29, 1996). The confidentiality policy of the Dorsey firm, applicable to respondent, is to the same effect. See J.A. 26-31. *Cf. Carpenter*, 484 U.S. at 322.

construed, made it reasonably clear at the relevant time that the defendant's conduct was criminal." *United States* v. *Lanier*, No. 95-1717 (Mar. 31, 1997), slip op. 7. The misappropriation theory was firmly established at the time of respondent's trades. See *United States* v. *Newman*, 664 F.2d 12 (1981) (upholding misappropriation theory), aff'd after remand, 722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983); H.R. Rep. No. 910, *supra*, at 11 (noting, during passage of ITSFEA, that misappropriation doctrine was already "well established and widely known").

d. Finally, there is no merit to the argument of *amicus* NACDL (Br. 10-14) that the invalidity of the misappropriation theory is demonstrated either by Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), creating strict liability for short-swing profits by corporate insiders, or the fact that the SEC did not rely on the misappropriation theory when it barred insider trading in *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). Section 16(b) creates liability for nonfraudulent as well as fraudulent trading, and covers only short-swing trading (purchase and sale within a six-month period). "Congress' failure to impose criminal sanctions for nonfraudulent conduct under Section 16(b) does not mean that it intended to immunize insider trading that is fraudulent under Section 10(b) and Rule 10b-5." *United States* v. *Lang*, 766 F. Supp. 389, 402 (D. Md. 1991). And the Commission's articulation of the "classical theory" rather than the misappropriation theory in *Cady, Roberts* reflects the fact that the information in that case was not converted from its rightful owner. See 40 S.E.C. at 917 (noting that corporate insider who gave information to broker "probably assumed, without thinking about it, that the dividend action was already a matter of public information").

3. a. Respondent argues (Br. 33-44) that Rule 14e-3(a) exceeds the SEC's authority under Section 14(e) because the Rule does not require that the trading on nonpublic

information breach a fiduciary duty. In so arguing, however, he makes no effort to respond to our point that the second sentence of Section 14(e) authorizes the SEC to "prescribe means reasonably designed to prevent fraud," which authority "necessarily encompasses the power to proscribe conduct outside the purview of fraud, be it common law or SEC-defined fraud." U.S. Br. 40 (quoting *Chestman*, 947 F.2d at 558 (opinion of Meskill, J.)).

Respondent does suggest (Br. 36) that the Court held in *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985), that the 1970 Amendments to the Williams Act, which added the second sentence of Section 14(e), did not expand the scope of the "fraudulent, deceptive, or manipulative acts" that are prohibited by Section 14(e). The Court in *Schreiber* noted, however, that even though the term "manipulative" in the first sentence of Section 14(e) includes only deceptive acts, the second sentence "gives the [SEC] latitude to regulate *nondeceptive* activities as a 'reasonably designed' means of preventing manipulative acts." 472 U.S. 11 at n.11 (emphasis added). *Schreiber* therefore recognized that, under the second sentence of Section 14(e), the SEC has authority to prohibit activity that would not constitute manipulation or fraud at common law, and would not be prohibited under the self-operative proscriptions of the first sentence of Section 14(e). Respondent does not answer our showing that prohibiting a class of trading in which a breach of duty is likely but difficult to prove is a "means reasonably designed" to prevent the fraudulent use of confidential information in the tender offer setting. U.S. Br. 43-44.

b. Respondent also contends that there was no "tender offer" within the meaning of Section 14(e) until Grand Met formally authorized and announced its bid, and therefore his trades, which took place before the announcement, did not violate Section 14(e) because they were not "in connection with a tender offer" within the meaning of that

Section. That argument (which was not addressed by the court of appeals) cannot be squared with the purpose of the Williams Act. Under respondent's construction of Section 14(e), bidders and others could engage in fraudulent and manipulative practices without liability under the statute until they announced their offer. If Section 14(e) did not govern at least some events before the formal tender offer, "either party would be free to disseminate misinformation up to the effective date of the tender offer, thus defeating in substantial part the very purpose of the [Williams] Act —informed decisionmaking by shareholders." *Lewis* v. *McGraw*, 619 F.2d 192, 195 (2d Cir.), cert. denied, 449 U.S. 951 (1980). The SEC, recognizing that at least some events before a formal tender offer must be covered to make Section 14(e) effective, has construed the "in connection with" language to encompass situations where a bidder has taken "a substantial step or steps to commence * * * a tender offer." That reading is a reasonable construction of the statute that is entitled to deference. *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

c. Under either of respondent's proffered constructions of Section 14(e)—limiting its reach to breaches of fiduciary duty, or limiting its temporal scope to actions taken after the formal commencement of a tender offer—the SEC would have no authority to prohibit "warehousing," the practice by which bidders leak advance information of a tender offer to allies and encourage them to purchase the target company's stock before the bid is announced. Yet the Court noted in *Chiarella* that at that time the SEC had proposed Rule 14e-3 to prohibit warehousing. The Court recognized that warehousing could be deleterious to the interest of shareholders in a company for which a tender offer has been planned but not announced, since in those situations, "the seller's behavior

presumably would be altered if he had the nonpublic information." *Chiarella*, 445 U.S. at 234.

d. Respondent also argues (Br. 41-44) that Rule 14e-3(a) is invalid because it criminalizes trading before a tender offer occurs without providing notice of when a violation occurs and without requiring scienter. Respondent did not present those arguments to the court of appeals; nor did he object to the district court's instruction to the jury that it was not required to find that respondent knew that the substantial steps had been taken. In any event, the contention is without merit. A violation of Rule 14e-3(a) requires proof that the bidder had taken "substantial steps" towards a tender offer. That standard is no more indefinite than is, for example, the Rule's other requirement that nonpublic information be "material," or the Sherman Act's predication of liability on violations of the "rule of reason." See *United States Gypsum*, 438 U.S. at 445. Even such "general statements of the law are not inherently incapable of giving fair and clear warning." *Lanier*, slip op. 12. And since a criminal violation of Rule 14e-3(a) requires proof of willfulness, *i.e.*, conscious wrongdoing (see pp. 12-13, *supra*), it is unlikely that the Rule will ever be a "'trap for the unwary,' imposing criminal sanctions on 'wholly innocent conduct.'" *Yermian*, 468 U.S. at 74. Moreover, the jury in this case found that respondent knew that the information on which he traded was nonpublic, material, and obtained directly or indirectly from the tender offeror, and that he acted with intent to defraud. See J.A. 204 (jury instructions on Rule 14e-3(a)). Under those circumstances, respondent cannot claim that he was punished for violating the Rule without scienter.

4. Finally, respondent argues (Br. 49) the mail fraud indictment in this case differs from the indictment in *Carpenter* v. *United States*, 484 U.S. 19 (1987), in that the indictment here describes the overall "scheme to defraud"

by alleging fraud "in connection with the purchase and sale of securities." J.A. 8. Respondent claims that if his fraud is not "in connection with" his securities trades within the meaning of Section 10(b), then there can be no fraud "in connection with" his securities trades for purposes of the mail fraud counts. That claim fails because the offense of mail fraud does not contain an "in connection with" element, the jury was not charged that it had to find that respondent's fraud was "in connection with" his purchase of Pillsbury securities on the mail fraud counts, and "[a] part of the indictment unnecessary to and independent of the allegations of the offense proved may normally be treated as 'a useless averment' that 'may be ignored.'" *United States* v. *Miller*, 471 U.S. 130, 136 (1985) (quoting *Ford* v. *United States*, 273 U.S. 593, 602 (1927)).[12]

In any event, respondent's argument does not distinguish the indictment in *Carpenter*. The *Carpenter* indictment first charged that the conspiracy involved "fraud in the purchase and sale of securities," as well as acts "in connection with the purchase and sale of securities" that operated as a fraud (using the language of Rule 10b-5). Resp. Br. App. 3a, ¶¶ 7-8. It then incorporated those conspiracy allegations into the substantive wire fraud counts. *Id.* at 15a, ¶ 40. There is, therefore, no material difference

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[12] In *Miller*, the Court upheld the permissibility of striking superfluous allegations from a mail fraud charge. Consistent with that doctrine, the trial court here did *not* charge the jury that it was required to find, as an element of the mail fraud counts, that the scheme to defraud was "in connection with" the purchase or sale of securities (or that respondent violated Section 10(b)). Rather, the court charged that the jury had to find that respondent had devised a scheme to defraud Grand Met or Dorsey "out of money, property, or property rights by purchasing Pillsbury securities while in possession of material nonpublic information" (J.A. 192). That is a conventional application of the law of mail fraud under *Carpenter*, and a reasonable construction of the indictment.

between the indictment in this case and that in *Carpenter*, and the court of appeals' departure from *Carpenter* cannot be sustained.

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For the forgoing reasons, and also for the reasons set forth in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General

APRIL 1997